Supreme Court, U.S.
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No. 85-1803

IN THE SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1985

SLAB FORK COAL COMPANY,

Petitioner,

v.

UNITED VIRGINIA BANK,
KANAWHA VALLEY BANK, N.A., and
THE CHARLESTON NATIONAL BANK,

Respondents.

On Petition For Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

JOINT BRIEF OF RESPONDENTS IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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The Charleston National Bank

QUESTIONS PRESENTED

1. Whether the United States Court of Appeals for the Fourth Circuit (the "Court of Appeals") properly held that cash proceeds received in payment for postpetition coal shipments made by a Chapter 11 debtor pursuant to a prepetition coal supply contract are subject to a valid prepetition security interest in the contract and its proceeds.

2. Whether the Court of Appeals properly held that the cash proceeds received by a Chapter 11 debtor's postpetition performance under a prepetition coal supply contract constitute cash collateral within the meaning of § 363(a) of the Bankruptcy Code.

3. Whether the Court of Appeals properly held that the filing of a petition in bankruptcy does not extinguish existing security interests in prepetition collateral or in the postpetition proceeds of prepetition collateral.

4. Whether there exists a conflict between the decision of the Court of Appeals and the decision of another federal court of appeals.

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JOINT BRIEF OF RESPONDENTS IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

I.

STATEMENT OF THE CASE

A. Nature of the Case

This is an action filed by United Virginia Bank, Kanawha Valley Bank, N.A. and The Charleston National Bank[1/] (all collectively referred to herein as the

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1/ United Virginia Bankshares, Incorporated is the parent company of United Virginia Bank, One Valley

(Footnote cont'd)

"Banks") to prohibit or condition the use by Slab Fork Coal Company (the "Debtor") of any cash collateral received from the postpetition sale of coal by the Debtor to Armco, Inc. ("Armco") pursuant to a written contract between the Debtor and Armco (the "Armco Contract") entered into prior to the Debtor's bankruptcy.

B. Statement of Facts

The facts are not in dispute[2/] and with the following additions those set forth by Slab Fork in its Statement of the Case are substantially complete.

The Armco Contract was executed in 1956 for a term of twenty years and was extended at the election

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(Footnote cont'd from previous page)

Bankcorp of West Virginia, Inc. is the parent company of Kanawha Valley Bank, N.A. and Centuron Bankcorp, Inc. is the parent company of The Charleston National Bank.

2/ No testimony was taken at trial. Instead, the parties stipulated the facts and accept as correct the Statements of Fact included in the pretrial briefs that the parties filed with the Bankruptcy Court.

of Armco in 1971 to a second term ending in 1996. Under the Armco Contract, the Debtor agreed to deliver monthly to Armco a certain quantity and quality of coal and Armco agreed to pay the Debtor on the twentieth of each month for coal shipped the previous month.

On June 1, 1981 the Banks and the Debtor entered into a Loan and Note Exchange Agreement (the "Loan Agreement") by which the Banks agreed to extend credit to the Debtor upon the conditions set forth in the Loan Agreement. The indebtedness under the Loan Agreement is evidenced by six promissory notes of the Debtor and a letter of credit issued by United Virginia Bank for the account of the Debtor.

Under the Loan Agreement, the Debtor granted to the Banks a security interest in all of the Debtor's assets, including "[a]ll accounts arising from the sale of coal...and the proceeds thereof" and "[a]ll accounts, general intangibles, chattel paper, documents, instruments ... and inventory ... whether now owned or

hereafter acquired, and the proceeds thereof." Financing statements under the Uniform Commercial Code ("UCC") perfecting the Banks' security interest in this collateral were properly filed in the locations prescribed by the UCC of West Virginia.

As of March 14, 1983, the date of the commencement of the Debtor's bankruptcy proceeding, Armco was indebted to the Debtor in the amount of $993,730.98 for deliveries of coal to Armco made prior to the filing of the petition. This amount was paid to the Banks by Armco without objection by the Debtor pursuant to an order entered by the Bankruptcy Court on April 27, 1983.

As of June 30, 1983, Armco had paid to the Debtor approximately $145,000 for shipments of coal made subsequent to the commencement of the Debtor's bankruptcy case. It is this amount, plus the proceeds from subsequent sales by the Debtor to Armco under the Armco Contract, which the Banks contend are subject to their security interest and hence "cash collateral" under § 363(a) of the Bankruptcy Code.

When the Banks asserted their security interest in the postpetition proceeds of the Armco Contract, the Debtor objected and the matter was heard by the Bankruptcy Court upon the Banks' Motion to Prohibit Use of Cash Collateral.

II.

REASONS FOR DENYING THE WRIT

The Debtor's petition for a writ of certiorari should be denied because there is no conflict between the holding of the Court of Appeals and the decisions of this Court or the decisions of other circuits. In addition, the Court of Appeals' decision is completely in accord with applicable statutory law and with the decisions of other federal courts.

A. The Court Of Appeals Properly Held That Cash Proceeds Received In Payment For Postpetition Coal Shipments Made By A Chapter 11 Debtor Pursuant To A Prepetition Coal Supply Contract Are Subject To A Valid Prepetition Security Interest In The Contract And Its Proceeds

The Debtor does not dispute and the Court of Appeals correctly held that the Banks have a valid and perfected prepetition security interest in the Armco Contract and its proceeds. United Virginia Bank v. Slab Fork Coal Company, 784 F.2d 1188, 1191 (4th Cir. 1986), petition for cert. filed, 54 U.S.L.W. 3744 (U.S. May 2, 1986)(No. 85-1803) reprinted in Appendix A-1, Petitioner's Petition for a Writ of Certiorari ("App."). The Debtor contends that the Banks' security interest extends only to the proceeds that the Debtor had a right to receive prior to the commencement of the case and not to proceeds generated postpetition under the Armco Contract.

11 U.S.C. § 552(b) assures that, notwithstanding the filing of a bankruptcy petition, a prepetition security interest in collateral and its proceeds extends to postpetition proceeds of that collateral. In re Chaseley's Foods, Inc., 726 F.2d 303, 305 (7th Cir. 1983); In re Village Properties, Ltd., 723 F.2d 441, 444 (5th Cir. 1984) cert. denied, 466 U.S. 974 (1984); see

also H.R. Rep. No. 595, 95th Cong., 1st Sess. 376-377, reprinted in 1978 U.S. Code Cong. & Ad. News 5963, 6333. Section 552 provides:

> (a) Except as provided in subsection (b) of this section, property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.
>
> (b) Except as provided in section 363, 506(c), 522, 544, 545, 547, and 548 of this title, if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds...of such property, then such security interest extends to such proceeds...acquired by the estate after the commencement of the case to the extent provided by such security agreement and by applicable nonbankruptcy law, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise. (emphasis added).

Section 552 does not deprive a secured creditor of its security interest in property acquired by the debtor prior to the commencement of the debtor's bankruptcy case. Neither does § 552 deprive a secured creditor of its rights to proceeds of property in which it acquired a prepetition security interest. The legislative history succinctly states:

> If the security agreement extends to proceeds...of property that the debtor had before the commencement of the case, then the proceeds, etc., continue to be subject to the security interest, except to the extent that the estate acquired the proceeds to the prejudice of other creditors holding unsecured claims.

H.R. Rep. No. 595, 95th Cong., 1st Sess. 376-377, reprinted in U.S. Code Cong. & Ad. News 5963, 6333.

Thus, accounts receivable and cash generated by a debtor's postpetition performance under a prepetition contract which is subject to a prepetition security agreement are proceeds of prepetition collateral within the meaning of § 552(b) and are subject to the same

security interest that encumbers the prepetition collateral. See J. Catton Farms, Inc. v. The First National Bank of Chicago, 779 F.2d 1242, 1246 (7th Cir. 1985); In re Sunberg, 729 F.2d 561, 562 (8th Cir. 1984).

The Court of Appeals correctly held that revenue the Debtor received from the Armco Contract constitutes proceeds of the Armco Contract. Slab Fork, App. at A-9. The law is clear that any cash generated by the Debtor's postpetition performance under a prepetition contract which is subject to a prepetition security interest is "proceeds" of the prepetition collateral within the meaning of § 552(b). See J. Catton Farms, 779 F.2d at 1246; Sunberg, 729 F.2d at 562; In re Air Florida System, Inc., 49 B.R. 321, 324 (Bankr. S.D. Fla. 1985); In re Hollie, 42 B.R. 111, 119 (Bankr. M.D. Ga. 1984); In re Liles and Raymond, 24 B.R. 627, 629 (Bankr. M.D. Tenn. 1982).

The Court of Appeals correctly found that Sunberg is dispositive. Slab Fork, App. at A-10. In Sunberg the debtors filed an application with the Bankruptcy Court to grant a postpetition lender a first lien on payments received pursuant to a contract with the federal government which was subject to a prepetition lien.[3/] The Eighth Circuit affirmed the Bankruptcy Court's denial of the debtor's application because the payments, which constituted proceeds of the contract, secured a prepetition loan from the Production Credit Association ("PCA").

The PCA had obtained a security interest in the debtor's contract rights and the proceeds thereof prior to the filing of the petition in bankruptcy. Sunberg, 729 F.2d at 562. The debtors argued that the payments were property acquired after the commencement of

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3/ The contract was entered into pursuant to the 1983 Payment in Kind Program (PIK) of the United States Department of Agriculture. Under the PIK Program, farmers received cash or crops in return for agreeing to leave farmland fallow.

their bankruptcy case and therefore were not subject to PCA's lien. Id. The Eighth Circuit held that the payments received under the contract after the filing of the petition were encumbered by the PCA's lien as proceeds of prepetition collateral pursuant to § 552(b). Id. In so holding, the Court stated:

> The Sunbergs attempt to avoid the lien on their PIK benefits by characterizing those benefits as property acquired after the commencement of their bankruptcy case under 11 U.S.C. § 552(a) (1982). If PCA's security interest covered the PIK contracts and the proceeds of pledged collateral prior to the Sunberg's petition in bankruptcy. however, the proceeds of those contracts realized after the petition would continue to be encumbered absent a bankruptcy court order to the contrary based on the equities of the particular case. Id. § 552(b).

Id.

The decision by the Seventh Circuit in J. Catton Farms is also directly on point. In J. Catton Farms, as in Sunberg, a lender acquired a prepetition security interest in the debtor's contract rights and the proceeds

thereof. The debtor contended that under § 552(a) the postpetition proceeds of the contract were not subject to the lender's security interest. Relying on § 552(b), the Seventh Circuit held that the postpetition proceeds were subject to the lender's prepetition lien in the contract and its proceeds. J. Catton Farms, 779 F.2d at 1246. As both Sunberg and J. Catton Farms demonstrate, under § 552(b) a creditor's security interest in postpetition proceeds of a contract which constitutes prepetition collateral continues even though the proceeds are generated by postpetition performance of the contract.

In the present case, as in Sunberg and J. Catton Farms, the Debtor and Armco executed the Armco Contract prepetition and the Banks' security interest in the Armco Contract and its proceeds attached prepetition. Thus, payments received by the Debtor from its postpetition performance under the Armco Contract constitute proceeds of prepetition collateral, not after-acquired property, and are subject to the Banks' security interest.

The Debtor attempts to distinguish Sunberg and J. Catton Farms by arguing that in those cases the debtors were not obligated pursuant to the PIK contracts to undertake any activities to earn the payments whereas payment pursuant to the Armco Contract was conditioned upon the Debtor's postpetition efforts to source and sell the coal to Armco. Contrary to the Debtor's contentions, under the PIK program a farmer not only agrees to remove acreage from production but also to maintain the land through USDA approved conservation techniques. Sunberg, 729 F.2d at 561-562; In re Schmidt, 38 B.R. 380, 382 (Bankr. D. N.D. 1984). As under the Armco contract the postpetition PIK payments received by the debtors in Sunberg and J. Catton Farms were generated by the debtors' postpetition activity. Sunberg, 729 F.2d at 561-562. Sunberg and J. Catton Farms are directly on point and are dispositive of the present case.

The Debtor cites In re Northeast Chick Services, Inc., 43 B.R. 326 (Bankr. D. Mass. 1984), In re Lawrence, 41 B.R. 36 (Bankr. D. Minn. 1984), In re Gross-Feibel, 21 B.R. 648 (Bankr. S.D. Ohio 1982), and In re All-Brite Sign Service Co., Inc., 11 B.R. 409 (Bankr. W.D. Ky. 1981) for the proposition that the Court of Appeals' decision is contrary to a line of cases holding that a security interest in prepetition collateral does not extend to postpetition proceeds of the collateral unless the debtor had an absolute right to receive the proceeds prepetition. Reliance on these cases by the Debtor is completely misplaced. Each is in accord with Sunberg, J. Catton Farms and the Court of Appeals' decision in the present case. Each stands for the proposition that postpetition proceeds of prepetition collateral in which a creditor has a prepetition security interest are encumbered by the prepetition security interest. Northeast Chick Services, 43 B.R. at 331; Lawrence, 41 B.R. at 38; Gross-Feibel, 21 B.R. at 649; All-Brite, 11 B.R. at 414.

It is clear that only the proceeds of property acquired prepetition, not proceeds of after-acquired property, are encumbered by the prepetition security interest. As the court in All-Brite stated

> The only limitation on the bank's ability to take a security interest in after-acquired accounts is that which was imposed by Section 552(a) of the Bankruptcy Code when All-Brite filed its petition. Section 552(a) precludes the fixing of a lien resulting from a pre-bankruptcy security agreement on property acquired after bankruptcy, and thus renders ineffective after bankruptcy the operation of an after-acquired property clause in a security agreement.
>
> Excepted from operation of this rule however, are the proceeds of secured property. Under Section 552(b) proceeds from property acquired before bankruptcy are still subject to a prebankruptcy security interest in them. All-Brite's postpetition deposit of proceeds, unless derived from accounts acquired after bankruptcy, was therefore subject to the bank's security interest. The bank is entitled to apply those proceeds to All-Brite's outstanding secured indebtedness.

All-Brite, 11 B.R. at 414.

In All-Brite, because the lender had a security interest in the debtor's prepetition accounts and

contract rights and proceeds thereof, the court found that the postpetition proceeds of prepetition collateral were subject to the lender's prepetition security interest. Id. As noted above, the Banks obtained a valid security interest in the existing Armco Contract on June 1, 1981. Having obtained a prepetition security interest in a contract that the Debtor acquired prepetition, the Banks have a valid security interest in the contract and its proceeds generated postpetition.

In Northeast Chick Services, Lawrence and Gross-Feibel, unlike the present case, the debtors acquired the collateral which generated the proceeds after the filing of the petition. In those cases, since § 552(a) abrogates after-acquired property clauses, neither the collateral nor the proceeds were subject to the creditors' prepetition security interests. Northeast Chick Services, 43 B.R. at 331; Lawrence, 41 B.R. at 38; Gross-Feibel, 21 B.R. at 649. In the present case, the Banks' security interest attached to the Armco Contract and its proceeds before the bankruptcy

petition was filed and hence under § 552(b) reaches the postpetition proceeds of the prepetition collateral.

B. The Court Of Appeals Was Correct In Determining That The Cash Proceeds Received By The Debtor's Postpetition Performance Under The Armco Contract Constitute Cash Collateral Within The Meaning Of § 363(a)

The definition of "cash collateral" found in the legislative history which accompanied the Bankruptcy Reform Act of 1978 specifically includes all cash, whenever acquired by the estate, which constitutes proceeds of property subject to security interests as provided in § 552(b). The legislative history states:

> The definition is not restricted to property of the estate that is cash collateral on the date of the filing of the petition. Thus, if "noncash" collateral is disposed of and the proceeds come within the definition of "cash collateral" as set forth in this subsection, the proceeds would be cash collateral as long as they remain subject to the original lien on the "non-cash" collateral under § 552(b). To illustrate, rents received from real property before or after the commencement of the case would be

> cash collateral to the extent that they are subject to a lien.

S. Rep. No. 989, 95th Cong., 2d Sess. 55, reprinted in 1978 U.S. Code Cong. & Ad. News 5787, 5841.

In addition to the clear statement found in the legislative history, in the Bankruptcy Amendments and Federal Judgeship Act of 1984 Congress supplemented the definition of cash collateral to include as an example of cash collateral "proceeds of property subject to a security interest as provided in § 552(b)." Thus, as the Court of Appeals correctly stated in the present case, Congress intended to include postpetition proceeds of prepetition collateral within the scope of cash collateral. Slab Fork, App. at A-11.

Because the payments received by the Debtor under the Armco Contract are proceeds of property subject to the Banks' security interest under § 552(b), those payments constitute cash collateral. The proceeds of prepetition contracts in which creditors hold security interests have been held to constitute cash

collateral under § 552(b) that cannot be used by debtors absent adequate protection for the creditor's interest in such collateral. In re George Ruggiere Chrysler-Plymouth, 727 F.2d 1017, 1020 (11th Cir. 1984); In re Hollie, 42 B.R. at 120. The Court of Appeals clearly was correct in holding that cash proceeds of prepetition contracts in which creditors hold security interests are not excluded from the definition of cash collateral found in the Bankruptcy Reform Act of 1978.

C. The Filing Of A Petition In Bankruptcy Does Not Extinguish Existing Security Interests In Prepetition Collateral Or In The Postpetition Proceeds Of Prepetition Collateral

Section 552 of the Bankruptcy Code strikes an appropriate balance between the debtor's need for a "fresh start" and the legitimate property interests of creditors. On the one hand, § 552(a) assures the debtor a fresh start by providing that property acquired after the commencement of the case will not be subject to a prepetition security interest. For example, proceeds of contracts that debtors enter into postpetition are

not subject to prepetition security interests. In re Fowler, 41 B.R. 962, 963 (Bankr. N.D. Iowa 1984).

On the other hand, § 552(b) assures that if the debtor and a secured party enter into a security agreement prepetition which attaches to property prepetition and to the proceeds of such property, then the security interest extends to the proceeds of such prepetition property generated by the debtor postpetition. J. Catton Farms, 779 F.2d at 1246; Sunberg, 729 F.2d at 562. In so protecting the interest of a creditor in secured property and the proceeds of secured property, § 552(b) assures creditors the protections to which they are entitled under the Fifth Amendment. George Ruggiere Chrysler-Plymouth, 727 F.2d at 1019. Thus, the Bankruptcy Code provides a debtor the opportunity to reorganize without divesting creditors of prepetition interests in prepetition collateral and in the proceeds of prepetition collateral.

Although the Debtor argues that the Banks' security interest in the proceeds of collateral

encumbered by a prepetition security interest hinders its reorganization efforts and deprives it of its "fresh start", the "fresh start" is not unlimited. For example, § 362(d) enables secured creditors in certain circumstances to obtain relief from the automatic stay to repossess and liquidate their collateral. Similarly, as the Court of Appeals held in the present case, a debtor cannot extinguish a creditor's security interest in the proceeds of prepetition collateral simply by filing a petition in bankruptcy. Slab Fork, App. at A-10. If a security interest in proceeds could be abrogated through the filing of a bankruptcy petition, contracts would have no value as collateral.

In enacting § 552 Congress balanced the competing needs of debtors for a "fresh start" and of creditors for certainty in the maintenance of their secured interests. The Court of Appeals correctly followed the provisions of § 552 when it reached its decision in the present case.

D. There Exists No Conflict Between The Decision Of The Court Of Appeals And The Decision Of Another Federal Court Of Appeals

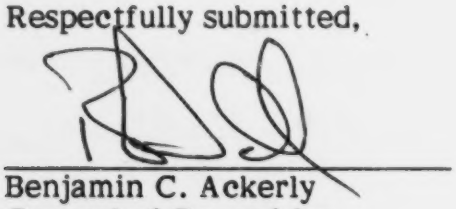
Rule 17 of the Supreme Court Rules provides that the Supreme Court will consider a review on writ of certiorari, "[w]hen a federal court of appeals has rendered a decision in conflict with the decision of another federal court of appeals on the same matter ...". No decision by any court of appeals conflicts with the decision reached by the Court of Appeals in the present case. Not only is there no conflict among the courts of appeals, but decisions by two courts of appeal are directly on point with the Court of Appeal's decision in the present case and are dispositive. J. Catton Farms, 779 F.2d at 1246; Sunberg, 729 F.2d at 562.

III.

CONCLUSION

For the foregoing reasons, the Petition for Writ of Certiorari should be denied.

Respectfully submitted,



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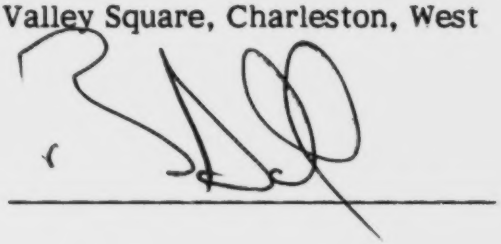
CERTIFICATE OF SERVICE

I HEREBY CERTIFY that three copies of the foregoing Joint Brief of Respondents in Opposition to Petition for Writ of Certiorari were mailed this 31 day of May, 1986 to Richard E. Rowe, Esquire, Goodwin & Goodwin, 1500 One Valley Square, Charleston, West Virginia 25301.



Sworn to and subscribed before me this the 31st day of May, 1986.

Lynn Cutright
Notary Public